

Central Intelligence Agency



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## DIRECTORATE OF INTELLIGENCE

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China's Urban Economic Reforms: Some  
Questions and Answers [redacted]

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Summary

China's ambitious economic reform program, which was formally endorsed at October's party plenum, has generated a wide range of questions about its nature. This typescript addresses some of the most frequently asked questions, including: how the Chinese program compares to Hungary's economic reforms and Lenin's New Economic Policy (NEP); whether China is approaching capitalism; and whether the reforms can be reversed.

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It is our judgment that although China's economic reforms are similar to Hungary's and the NEP, they differ significantly in the first instance in their implementation--because of the vast differences in the two economies--and in the second, in their intended permanence. The reforms will allow market forces a greater role in allocating resources, but China's economy will remain essentially socialist. We believe it will be difficult to undo the reforms once established, but we expect Beijing to tighten and loosen guidelines to meet the inevitable dislocations. We do not rule out the possibility that, under certain circumstances, China might retreat to tighter central control as it did in 1981. It is very unlikely, however, that future leaders would return to the demonstrably bankrupt economic policies of Mao. As the reforms are phased in, we believe the opportunities for Western businesses, including US firms, will increase. We also expect increased Chinese demand for advanced technology and easier access to US markets.

[redacted]

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\*This memorandum was prepared by [redacted] China Division, Office of East Asian Analysis. Comments and questions are welcome and should be directed to Chief, Domestic Policy Branch, OEA, [redacted]

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What Are The Reforms?

Experiments with individual urban reforms have been under way since 1979, but October's Third Plenum of the 12th Party Congress was an important benchmark in Beijing's campaign to alter fundamentally the way the regime makes economic decisions. The plenum's key document, "Decision on Reform of the Economic Structure," officially placed the party's stamp of approval on specific policies, provided essential Marxist justification, and placed the urban reforms in the broader context of the party rectification effort and the successful agricultural reforms. [ ]

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The policies themselves seek to change the structure, method, and incentives of industrial management in order to improve efficiency and thus industrial performance. The urban reforms are more complicated than the agricultural ones and as such are more dependent for their success on all aspects working together. The most important are:

--Reform of the Planning System. China is gradually moving away from the rigid central planning system that it modeled on the Soviet Union. Under the reforms, production of certain items of national importance--such as steel, petroleum products, chemicals and foodgrains--remain under mandatory state quotas. Most products, however, are to be produced under "guidance plans" that are set by the state but that the enterprises can adjust to meet changing markets. Consumer items and over-quota production of most goods are to be regulated by China's equivalent of an open market. [ ]

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--Enterprise Autonomy. A major goal of the reforms is to increase the authority of enterprise managers and reduce the power of party and government officials in economic decisionmaking. Managers already have more power to develop production and marketing strategies, hire and fire workers, and set prices and wages; the power of central ministries and provincial governments is reduced correspondingly. Competition between enterprises is encouraged. [ ]

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--Price Reform. In perhaps the most important reform, Beijing has begun to adjust domestic prices. Prices of key products--such as coal and oil--will still be set by the state but at levels that better reflect relative scarcities in the economy. The prices of many other products--including most manufactures--are allowed to fluctuate within bounds set by the state in response to market conditions. Supply and demand alone determines the prices of minor consumer goods such as certain clothing products, cosmetics, and even minor foodstuffs. [ ]

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--Wage Reform. Wages, once guaranteed regardless of output or qualifications, will now reflect job performance. Workers with greater productivity will receive higher wages. Wages will reflect seniority, the cost of living, and skills in great demand. [ ]

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--Tax System. Instead of turning all profits over to the government, enterprises pay taxes and retain the remaining profits. Enterprise managers can use after-tax profits for worker bonuses, investment, and so forth. [ ]

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--Bank Reform. The banking system is being reorganized. Bank loans are increasingly replacing government grants as the source of capital for enterprises. [ ]

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--International Trade. International trade and foreign investment in China is being further encouraged. City and provincial governments have expanded authority to deal with foreign firms. Foreign trade enterprises, which will be allowed greater leeway in doing business, can now operate as commissioned agents for manufacturers and importers of most products. Foreign firms engaged in joint venture production can sell their output domestically as long as the venture's foreign exchange expenditures and receipts are balanced. [ ]

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When The Reforms Are Fully Implemented Will China Have A Capitalist Economy?

Although a distinct departure from orthodox central planning, these reforms will not transform China into a capitalist economy. The state will continue to own the means of production, and will still have direct control over output, pricing, and distribution of key products. Output of other products will continue to be regulated according to guidelines established by the state. The state will also retain the right to appoint or remove enterprise managers and shut down inefficient enterprises. [ ]

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Entrepreneurs have been allowed to establish small privately-run enterprises such as repairshops, restaurants, and tailor shops, but these activities now involve only 1 to 2 percent of the nonagricultural labor force. In the countryside, farmers lease land from the state, and contract with the government to produce a given quantity of output. [ ]

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China's leaders are committed to retaining the essential socialist nature of their economy, and are very sensitive to charges that they are introducing capitalist reforms. Western press depiction of the reforms as "capitalist" provides ammunition to the opponents of reform. [ ]

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How Do The Chinese Reforms Compare With Hungarian Economic Reforms?

The Chinese reforms are similar to those in Hungary, but the dissimilarities between the two economies suggest to us that they will follow different courses. Granting enterprise managers more autonomy, decentralizing banking, enhancing work incentives, and basing prices on market conditions, are important components of reform in both countries. The similarity of reform initiatives is due, in part, to the frequent consultations between Chinese and Hungarian economists over the past few years. [ ]

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How the reforms actually unfold will be strongly influenced by the special characteristics of each country.

--China has a continental economy and is largely self-sufficient, while the Hungarian economy is far smaller and heavily dependent on foreign trade. Hungary's reliance on trade has enabled it to use world prices as a reference for setting domestic prices. China will be more likely to adjust prices to domestic market conditions.

--Compared with Hungary, China's vast market, abundance of labor, and rich resources make it more attractive to foreign investors.

--China lacks the well-educated managers and technocrats that are needed to run autonomous enterprises. Hungary has more experience with economic reform, and has better educated managers available, including sophisticated bankers. [REDACTED]

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Political differences are also significant. Deng Xiaoping fully supports the reforms, and has the political clout to coopt or override any opposition that may arise. Janos Kadar not only must satisfy reform opponents in his party, but must also consider the Soviet reaction to Hungarian reforms. [REDACTED]

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#### How Do The Reforms Compare With Lenin's New Economic Policy?

There are pronounced similarities between China's recent economic reforms and elements of Lenin's New Economic Policy (NEP), which was launched in March 1921. As with the Chinese reforms, Lenin's program was designed to establish incentives for increases in labor productivity and efficient management of enterprises. [REDACTED]

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In the Soviet countryside, an in-kind tax on agricultural production replaced the onerous policy of forced requisitions of output. Farmers were allowed to keep production in excess of the tax and were permitted to hire laborers to help with farm operations, measures similar to those introduced in China. [REDACTED]

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Small enterprises were leased to private managers, or in some cases, returned to their original owners. Managers of state enterprises were given enhanced decisionmaking authority to dismiss incompetent and reward productive workers. Enterprises could use a portion of their profits to pay bonuses to workers and managers. [REDACTED]

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Foreign investment in Russia was encouraged. Large enterprises not operated by the state could be leased to foreigners. [REDACTED]

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Unlike the Chinese program, the NEP was launched in the midst of economic stagnation and peasant revolt brought on by abrupt nationalization of industry and agriculture. China's rural population has been relatively passive for more than 30 years following Beijing's introduction of strict state control. Lenin rationalized the NEP as a necessary transitional

phase in the march to communism. China's leaders today emphasize that reforms must occur because China is at the "commodity economy stage"--a precursor of true socialism. [REDACTED]

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Four years after the death of Lenin, the experiment with economic liberalization ended. Although the reforms had restored industrial and agricultural production to their pre-war levels, Stalin decided to pursue a different policy. The approval of the first Five Year Plan brought with it collectivization of Russian agriculture and an emphasis on rapid development of heavy industry under state guidance. The Chinese intend their reforms to last well into the next century. [REDACTED]

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#### What Are The Risks Of Reform?

The risks to the reform program are two-fold: short-run economic and social disruptions that may occur as the reforms are introduced; and political opposition within the party itself.

Two potential economic problems of special concern are inflation and unemployment. As central control over prices is relaxed, we expect the combination of shortages of consumer goods, pent-up demand, and large savings accounts to cause a sharp rise in prices. To preserve the real income of urban workers, and to forestall widespread dissatisfaction, the state may have to increase wage subsidies, thereby worsening budget deficits. We do not believe, however, that any long-term price spiral will ensue because the fiscally conservative government is unlikely to resort to use of the printing press to finance consumer spending. [REDACTED]

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If the state ends subsidies to losing enterprises, inefficient factories may be forced to close. Since labor mobility is low in China, pockets of relatively high unemployment could result that will be difficult to relieve. [REDACTED]

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In the political arena, we believe there is opposition to the reforms from party bureaucrats who lose power as decisionmaking is decentralized, and from ideologues who are disturbed by the departure from the egalitarianism of the Maoist era. Although clearly on the defensive, we believe opponents of reform will seize any short-term problems to argue for a return to more orthodox central control. [REDACTED]

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On the other hand, a successful reform program could conceivably lead to demands for further economic decentralization and consequently controversy in the party--possibly even in the reform wing. Although not inevitable, popular pressure for additional reform may eventually be accompanied by demands for political liberalization. [REDACTED]

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We believe that China's leaders are well aware of the risks inherent in the reform program, and are therefore proceeding cautiously in implementing it. [REDACTED]

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## Are The Reforms Reversible?

The urban economic reforms are controversial, and until firmly established and proven successful, they could be reversed. We believe, however, that any leadership would see compelling reasons to continue the reform program.\* The party has invested considerable prestige in the economic reforms, which are being touted as evidence of the party's legitimacy and vitality. A wholesale retreat from the reform program would seriously damage the party's prestige domestically. Scrapping reforms would also harm China's growing--and profitable--relations with the West and Japan. A reversal of China's "open door" policy would seriously jeopardize China's ability to acquire advanced technology, and international relations could suffer if foreign investors were treated poorly. [redacted]

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Because the agricultural reforms are better established--and successful--future Chinese leaders probably would find them particularly difficult to reverse. We believe that "re-collectivization" would anger China's most productive farmers--primary beneficiaries of reform--and would cause a large decrease in agricultural output, widespread rural dissatisfaction, and possibly instances of violence. [redacted]

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As urban economic reforms are implemented, we expect interest groups will develop to support them. Productive workers and efficient managers will benefit from a policy that allows wages to reflect effort. Technocrats will receive higher income and greater social status. As the bureaucratic structures to implement reforms are put in place, it will become more difficult for a future government to dismantle them. [redacted]

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Nonetheless, the party's first priority is to maintain social control and its own dominant position. If urban reforms produce serious economic disruptions or civil strife, the party will be compelled to modify them and will accept the costs of doing so. We believe a reemphasis of central planning will be more probable under those circumstances than a return to the Maoist egalitarianism of the Cultural Revolution. For instance, enterprise managers might be allowed to maintain limited decisionmaking authority, but the state would probably prohibit managers from firing workers if unemployment problems became acute. Inflationary pressures could lead Beijing to set narrower bands within which prices are allowed to fluctuate; free market operations might also be restricted. If budgetary problems become severe, Beijing would probably raise tax rates rather than reintroduce the profit remittance system that it abandoned under reform.

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\*Deng Xiaoping is credited with being the driving force behind the reform effort and his death is most often cited as the most likely cause for retreat. We believe his chosen successors, Hu Yaobang and Zhao Ziyang, are fully committed to economic reform, but they lack Deng's political clout and connections. We believe they would work hard to maintain the reforms, but new initiatives may be much less likely. [redacted]

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Firms might be discouraged from competing with each other if major shortages of raw materials developed, or if prices of export products began falling sharply or import prices rising rapidly. [REDACTED]

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#### What Are The Implications For The United States?

We believe that Chinese economic reforms will lead to expanded trade and investment opportunities for US businesses. Increases in real per capita income may even lead to greater demand for foreign products. In any case, Beijing is seeking additional foreign investment and is attempting to make terms more attractive. [REDACTED]

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The reforms are also likely to aggravate some current problems:

--Increases in Chinese industrial output will probably lead to greater demands by China for an easing of restrictions on sales of Chinese textiles and light industrial products in the United States. There may also be more frequent complaints from US companies about Chinese "dumping" in the United States.

--Continued success of agricultural reforms in China may cause decreases in sales to China of grain, cotton, and synthetic fiber. Eventually, China may compete with the United States for international sales of some agricultural products, particularly cotton.

--Eventually, US allies may face stiff competition from Chinese exports of light industrial products.

--Economic development will also probably increase Beijing's appetite for advanced technologies. [REDACTED]

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8  
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